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China's Financial Progress

BY ARTHUR N. YOUNG

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China's Financial Progress

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with the aid of the Research Staff of the Foreign Policy Association

(This report reviews the development of China's finances in the 10-year period before the outbreak of the Sino-Japanese war.)

TEN years ago the Chinese Nationalists established their capital at Nanking. With the fall soon after of the Peking republican régime, whose authority had long been mostly nominal, the National Government at Nanking became the recognized government of China. By 1937, through the efforts of that government, China had become substantially unified for the first time in many years. Under that government's guidance China was making rapid headway both in political organization and in the fields of economic and financial development. With a large territory, great natural resources, a numerous population of demonstrated industry and ability, and a progressive government, China was in the way to become a prominent economic factor in the world. China also had the prospect within the not too distant future of taking rank as one of the world powers. The temper of the people and their history promised that China would be one of the liberal powers, influenced by western types.

Now that the Sino-Japanese hostilities have ushered in a new phase of China's history, it is opportune to review the development of China's finances in the last decade. Particularly in these times, finance and politics are intertwined. The ability of the National Government to find large fiscal resources from the increase of tax revenues and development of the market for internal loans has been a major factor making possible the progress that has taken place.

In 1926 a writer on China's finances[1] thus summed up the situation:

1. F. E. Lee, *Currency, Banking and Finance in China* (Washington, Department of Commerce, 1926), p. 124.

"One of the most apparent needs of China today is a real fiscal system, yet it will be difficult to establish such a system on a solid foundation until the currency of the country is reformed. At this point the student of Chinese finance begins to argue in a circle, for the currency cannot be reformed until a strong central government can be set up. . . . A real fiscal policy cannot be established until a government has the power to levy and collect taxes and bring the proceeds of such taxes into its central public treasury. . . . Such a government cannot be set up . . . without money. This money is not forthcoming from revenues, and the country's ability to float a loan, either at home or abroad, has almost disappeared, due to numerous defaults."

China, it was recognized, had the wealth and resources to support an adequate fiscal system, but effective methods of drawing on them had yet to be devised.

Following the collapse in 1911 of the old Imperial régime, the development of a real central authority in China was prevented by lack of fiscal resources. The somewhat mediaeval revenues on which the Imperial Government had chiefly relied were at best insufficient to support a modern state. These revenues were collected under a decentralized system whereby the provincial authorities had practical autonomy in fiscal matters. Under these conditions it was only natural that the warlords who sprung up in the provinces should consume most of such revenues as existed. The inability of the successive Peking governments properly to finance the essential services of the state rendered such governments weak and ineffective. Their defaults on a large part of the foreign and domestic loans previously contracted ruined China's credit. Escape from this situation was more difficult because the Peking régimes developed no leadership capable of the really formidable task of organizing the country.

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In these circumstances the vigorous Nationalist movement stemming from the idealism of Dr. Sun Yat-sen became China's best hope of progress. The fall of Peking to the Nationalist northern expedition in the summer of 1928 led to momentary nominal unification, but the foundation of real unity had yet to be laid. The years 1929 and 1930 saw severe civil wars in which the National Government vindicated its authority and extended its sway, but effective unification remained far from complete. Communist forces challenged the government's program of setting up a moderate régime, and long campaigns were required before they were defeated and driven to the distant northwest by 1935-1936. These operations not only required heavy expenditures but also interfered with normal economic activities and distracted attention from constructive efforts. Nevertheless the National Government steadily pursued its program of national development.

In this task political, military and financial measures went hand in hand. Fortunately for China, the struggle of the Nationalist group for ascendency brought to the fore the leadership that previously had been lacking. Outstanding have been Chiang Kai-shek in the political and military field, and T. V. Soong and H. H. Kung in the field of finance. Perhaps the most notable qualities they have brought to bear on the tremendous problems that have arisen during these eventful years have been courage and resourcefulness. There have been many dark days—when the national authority was challenged by warlords or regional leaders, seizing national revenues and overriding agencies of the Central Government; when, as in 1931, floods rendered homeless tens of millions throughout 40,000 square miles; and, above all, when external aggression backed by overwhelming force brought about the seizure and attempted the domination of parts of China in which lived from one-fourth to one-fifth of its population. But through it all and in spite of setbacks and mistakes, the leaders have kept their will towards progress and realization of the aims to be achieved. China has shown a vitality and virility, grounded in its remarkable past, which give hope for a future in keeping with the past.

TAX REFORM

The first important step in establishment of an adequate fiscal system was the attainment of tariff autonomy. Under the old treaties China was limited to duty rates of 5 per cent *ad valorem*. The yield of such a limited tariff left practically nothing for the government after meeting debt service. In the five years 1924-1928, foreign loan and indemnity service absorbed 78 per cent of the net customs revenue, and practically all the rest went to pay internal debts under arrangements made in 1921-1922.[2] The Washington treaty signed February 6, 1922 provided for conditional increase of tariff rates to not over 10 per cent *ad valorem;* but application of even this limited measure of relief was delayed as a result of non-ratification of the treaty by France pending settlement of a controversy on another matter. Meanwhile, the Peking government languished without the contemplated additional revenue which was so much needed.

The Sino-American treaty of 1928 broke new ground by granting to China "complete national tariff autonomy," subject to avoidance of any discriminatory treatment. This treaty was followed by other similar treaties, the Sino-Japanese treaty of 1930 completing the grant of tariff autonomy. A three-fold increase of customs revenue resulted from the ensuing upward revisions of rates. Although particular rates have at times been pushed to levels that led to evasion or reduced importation, the customs revenue has been both dependable and productive.

Salt Revenues

Next in importance to customs has been the revenue from salt which, though an old revenue, had been so administered that the Central Government got comparatively little from it. Twenty-five years ago the salt administration had been reorganized with the help of foreign personnel, in order to serve as security for the Reorganization Loan of 1913. For a time the new system succeeded in bringing into the coffers of the government the greater part of the revenue collected. But, with the disintegration of the Peking régime, there was no means to prevent provincial warlords from seizing these funds. Being derived from widely distributed sources throughout China, the salt revenue was vulnerable to such seizure. At the time of the triumph of the Nationalist movement in 1927-1928, so much of the salt revenue had been seized that even the relatively small amounts required for loan service were not forthcoming and the loans had gone into default.

On November 16, 1928 Finance Minister Soong made an announcement concerning the rehabilitation of the Chief Inspectorate of Salt Revenue, stating that the regulations governing the Inspectorate had been revised "in order to make it an effective part of the National Government under the exclusive control of the Ministry of Finance."

2. Cf. Wright and Cubbon, *China's Customs Revenue since the Revolution of 1911* (Shanghai, Inspectorate General of Customs, 1935), pp. 441 and 416-25.

A system for allocation to the various districts of quotas sufficient to cover loan service was instituted. The Ministry of Finance undertook full responsibility for loan service. This action gave rise to objection by the foreign governments concerned, and has been criticized by bondholders as a departure from the terms of the 1913 loan agreement. The action was supported, however, on the ground that the old procedure had so broken down that in the then existing internal situation it could not be restored; and that, granted the temper of the country at the time, a scheme such as that adopted was the only feasible solution of the problem. Further, it has been argued that the claim of the Reorganization Loan on the salt revenue, although continuing, is of only academic interest inasmuch as in pursuance of the loan agreement the loan service funds have been regularly provided out of customs revenue since about 1917.

In any event, the measures adopted have made possible the effective restoration of the salt administration throughout the country. In 1936 the total collected was more than double the maximum yearly amount collected under the former régime, although the latter included collections in Manchuria. These measures have made possible the rehabilitation of the loans paid from salt revenue, whose prices in the first half of 1937 were more than double those of ten years before.

Other Reforms

It was clear from the outset that a fundamental reform of the system of internal taxation was necessary. This involved the abolition of exactions which unduly hampered trade—notably *likin,* a tax on the movement of goods which was collected at numerous barriers throughout the country. But since the flow of public revenue could not be interrupted, new and improved forms of taxation needed to be devised. The government logically looked to taxes on commodities. One of the early steps was the conclusion of agreements between the Ministry of Finance and leading oil and tobacco companies under which they agreed to pay increased taxes to the National Government, and the latter undertook to reimburse them in case their products were subjected to additional taxation in the interior. The administration of the new taxes was entrusted to special organizations which are now consolidated into the Internal Revenue Administration. At present, nine commodities have been incorporated in the system of consolidated taxes: rolled tobacco, cotton yarn, flour, matches, cement, flue-cured leaf tobacco, beer, mineral products and alcohol.

Meanwhile great progress has been made in abolishing burdensome taxes. In spite of the urgent need for revenue, the government decreed the abolition of *likin* in January 1931. Progress toward its abolition has since occurred, although it still prevails in certain sections of the country. Native customs levies, comprising duties on junk-borne trade, were also abolished in 1931, as were coast trade duties and transit dues. Certain reductions and exemptions from export duty have also been introduced. Moreover, steps have been taken to abolish miscellaneous exorbitant taxes and levies imposed by provincial and local governments. These measures have been worked out at special conferences convened by the Minister of Finance, and by administrative action of the Ministry.

The persistence of regional ideas, deeply rooted in the former system of virtual fiscal autonomy of the provinces, has been a constant problem for the government, which has had to be alert to defend its prerogatives. Frequently the government has arranged subsidies in exchange for taking over revenues collected in a particular area, thus extending its control. The relative freedom of customs revenue from local interference has been a source of great strength to the Central Government. There have, however, been several unfortunate instances of interference. Regional authorities seized the customs revenue at Tientsin in 1930 and at Canton in 1931, but neither of these interferences lasted long.

Much more serious has been the Japanese seizure of customs in Manchuria, revenue from which for the five years before 1932 averaged about 15 per cent of the total. Under the Japanese occupation, none of the collections since mid-1932 have been made available for service of China's obligations secured in part thereon. It is stated that a portion of these collections has been set aside for loan service; but the conditions of obtaining this contribution, if they had been accepted, would have amounted in effect to China's recognition of "Manchukuo." Similarly, the salt revenue was seized, not even loan quotas having been remitted. Serious loss of revenue, at one time about $2,000,000 Chinese currency weekly, also resulted from smuggling in North China. From about the beginning of 1935, when the Japanese authorities forced the disarmament and withdrawal of Chinese customs patrol vessels and refused to allow shore officers to carry arms, organized smuggling developed on a huge scale. A party engaged in smuggling was quoted in the press as offering to bring in anything desired, "except perhaps an elephant." Material loss of revenue continued, although somewhat checked

by customs supervision of inland distribution of smuggled goods moving out of the area affected.

The increases of the chief sources of revenue are shown in Table I. These gains have been achieved despite the seizure in Manchuria of about $60,000,000 in Chinese currency of customs and salt revenue (on the basis of 1931 collections), and Japanese-sponsored smuggling operations in 1935 and after.

TABLE I

(figures in millions of dollars, Chinese currency)

	*Customs**	*Salt*	*Consolidated taxes*	*Total*
1929	245	85	39	369
1930	292	130	40	462
1931	389	155	74	618
1932	312	145	83	540
1933	340	159	89	588
1934	335	176	113	624
1935	316	184	116	616
1936	325	205	136	666

*Including native customs and surtaxes.

DOMESTIC LOAN POLICY

The needs of the new government were too urgent to be satisfied only by development of tax revenues, which is a matter of months or years. Funds were immediately needed to put down subversive movements, and to commence a program of internal reconstruction. Without these additional funds the government could not have subsisted. Although internal loans had been issued in China during previous decades, they had been only irregularly paid. The National Government, however, set out to develop a capital market based on the performance of its promises to pay. Increasing revenues provided substantial security. Shanghai was a rich and growing metropolis, in which were centered the country's financial resources. Modern Chinese banks were rapidly developing, and were glad to buy the bonds or to lend to the government against them as a profitable investment. A system of loan service committees was instituted, composed of representatives of the Ministry of Finance and of the bankers and the bondholders. Each month the government deposited with such committees sufficient sums to provide for loan service payments as they became due.

Through such procedure, the National Government raised substantial amounts beginning in 1927. The cost of these loans was high, but they provided resources which were indispensable to the government and which eventually were decisive in enabling it to overcome the forces of disunity. There were complaints from time to time that the government should not have contracted these internal loans at a time when many older external and internal obligations were in default. This contention cannot be sustained on practical grounds, at least in so far as the provision of funds that were necessary to enable the government firmly to establish itself is concerned. There would otherwise have been no agency capable of reorganizing the finances and resuming payments on the older obligations. It is a well-recognized principle that in certain circumstances a debtor in default may be entitled to new money required to place his house in order.

It was inevitable that the government, in its huge task of rehabilitation, should incur substantial deficits which had to be covered by borrowing. With revenue expanding, however, the deficits proved capable of management in one way or another without recourse to currency inflation. A major difficulty in financing was the fact that the banks and other buyers of internal bonds, seeing the uncertainty of both internal and external political and economic developments, insisted on relatively short-term obligations. Hence the bonds, in order to be marketable, provided for repayment of principal at such a rapid rate as to make a heavy drain on revenues. For example, the 19th year Treasury Bonds of $80,000,000, Chinese currency, issued as of August 1930, bore interest at 8 per cent per annum, principal repayment to be completed by May 31, 1935, in monthly instalments which after 18 months were at the rate of nearly $20,000,000, Chinese currency, annually. Since these loans were taken at a discount, the cost was high—frequently 12 to 14 per cent per annum.

The system of heavy amortization payments was especially vulnerable to adverse developments. The Japanese seizure of Manchuria in the fall of 1931, besides impairing revenues, caused a severe shock to the domestic bond market. This situation was accentuated by the unrest in south China, the great flood of the summer of 1931, and the change of government in December 1931, followed by the Japanese invasion of the Shanghai area in January 1932. In these circumstances, it was necessary to effect a reorganization of the internal debt. In February 1932, as a result of discussion between the Ministry of Finance and representatives of the bondholders, it was arranged that the terms of most of the internal loans be lengthened and the interest rate reduced to a flat 6 per cent. As a result, internal loan charges were reduced by about $100,000,000, Chinese currency, yearly.

This measure, together with the most severe retrenchment on the part of the government, made possible the balancing of income and outgo during the calendar year 1932. The further Japanese encroachments in North China at about the begin-

ning of 1933, however, entailed additional expenses for military campaigns. The cessation of this fighting toward the middle of 1933 did not leave the government at peace. There remained the problem of putting down the ill-starred Fukien revolt at the beginning of 1934; and, much more important, the campaigns to suppress the Communist forces which had over-run part of the province of Kiangsi and other areas. Emergency expenditures for this latter purpose continued to 1936.

Owing to these conditions, coupled with the economic depression which in China was most severe in 1934-1935, the burden of internal debt payments again became too heavy to be borne. Once more this was caused by heavy near-term principal payments. A further reorganization of the internal loans was therefore effected in 1936, with savings of approximately $85,000,000 Chinese currency, yearly. This time occasion was taken to simplify the debt structure by converting over 30 separate internal obligations into a single 6 per cent consolidation loan of $1,460,000,000, Chinese currency, issued in five series, with repayment spread over about 25 years.

BUDGETARY CONDITIONS

The following table summarizes revenues and expenditures:

TABLE II

(in millions of dollars, Chinese currency)

Year ending June 30	*Net total payments (excluding cash balances at end of year)*	*Net total revenue (excluding net proceeds from borrowing)*	*Deficit*
1931	774	557	217
1932	749	619	130
1933	699	613	86
1934	836	689	147
1935	941	745	196*
1936	1,025	800	225†
1937	991	866	125‡

*Including $73,500,000 representing capital items.
†Estimated.
‡Budget estimates.

These deficits, it is worthy of note, have been offset in large part by payments for debt retired.

The outlook at the middle of 1937 was in fact far more favorable than is indicated by the above figures. China enjoyed record crops in 1936 and generally good crops in 1937. The currency reform of November 1935 had been a success, and had led to a large measure of economic recovery; in turn, the economic improvement taking place throughout the world was reacting favorably on China. Customs revenue in the first half of 1937 was about 60 per cent greater than in the previous year.[3] Salt and other internal revenues were also increasing. The country was free from civil war, a condition which promised to continue. The possibility of external complications appeared to be decreasing. Solid progress was being made in reconstruction, through rehabilitation of the railways, water conservancy, road building, development of airways, modernization of cities, and industrialization. Confidence was being strengthened by settlements of debts in arrears. New foreign credits were being arranged, which would both stimulate China's development and benefit industry in other countries. Measures were about to be placed in effect for reorganization of the Central Bank as a Reserve Bank, and the strengthening of the banking system was being planned. China's national debt was not large, being less than $10, Chinese currency (say U. S. $3.00), per capita. With reasonable control of public expenditures, the stabilization of the public finances was within reach.

CURRENCY REFORM

Although the reform of China's currency had been actively discussed since about 1900, it could still be authoritatively stated in 1929 that "China has unquestionably the worst currency to be found in any important country of the world."[4] At about the same time, another writer stated: "The currency in China is chaotic; it forms the most complicated mixture of heterogeneous mediums of exchange, from a weight to a coin, that has ever existed in any one country."[5] The major problem of currency reform in China was two-fold: the establishment of a uniform and convenient medium of exchange, and the adoption of a monetary standard.

The spread of the use of the silver dollar and, in recent years, the growing use of bank-notes with the value expressed in terms of dollars were gradually introducing an element of uniformity. The Spanish dollar and, later and more important, the Mexican dollar had become popular in China during the last century. Although use of the different kinds and weight of *taels* (ounces) persisted, the dollar medium gradually made headway as the chief standard for prices. By 1933 the government felt itself in a position to deal with this problem, and prescribed that the standard silver dollar should contain 26.6971 grams of silver 880 fine, and that the *tael* should be abolished. Thereafter, large numbers of standard dollars were coined and circulated. This was a notable step toward uniformity,

3. Part of this increase reflected improved control of smuggling in 1937, as previously mentioned.

4. *Report of Commission of Financial Experts* (Kemmerer Commission), 1929.

5. Passeri, quoted by Lee, *Currency, Banking and Finance in China,* cited, p. 8.

establishing the dollar system throughout China except for certain southern and western provinces.

It had long been recognized both by foreign monetary experts and by thoughtful financial leaders that China was in an anomalous position in basing its monetary system on silver, a standard different from that of practically all the rest of the world. Yet China's long adherence to the silver standard brought some advantages to the country. An essentially bullion standard, deriving from a metal of not too great value in relation to bulk, offered definite safeguards to the public in a period of disturbed internal conditions. In a country without a well-developed credit system, silver was a storehouse of value for savings. Moreover, the value of silver sometimes moved more with that of commodities in general than did gold. Thus in 1929-1932, the fall of silver prevented China from suffering depression along with the rest of the world, even though it led to some inflation.

But, on the whole, the old currency system put the country at a disadvantage. Instability of exchange hampered foreign trade, development of which was vital to China's progress. For some decades silver had been less stable in value than gold, although changes in the price level on the silver standard could hardly be shown to have been a more serious factor in China's economic life than have been corresponding changes in gold-standard countries. Yet most of the rest of the world had an interest in giving gold a proper status as the leading monetary metal, while no such widespread motive affected silver.

Although falling silver helped China to escape for a time the major evils of the recent depression, from the autumn of 1931 onward the successive British, Japanese, American and other devaluations led to an increase in the value of China's metallic currency relative to other currencies. As a result, deepening depression was felt in China, along with the well-recognized phenomena of deflation. The rise in the price of silver accentuated the deflation. With a free silver market in China, the value of silver there followed the world price, and a rising value of silver in China amounted to the same thing as a fall in the level of prices quoted in terms of silver. The index of wholesale prices at Shanghai, which had risen from around 100 in 1928 to 131 in the summer of 1931, fell to 91 in the summer of 1935. The drain of several hundred million Chinese silver dollars to foreign countries forced the contraction of credit in China, accompanied by the characteristic phenomena of unemployment, stagnation, banking difficulties and business failures.

On October 14, 1934 the Chinese government announced that exports of silver were restricted, and were allowable only on payment of duty and equalization charge representing the difference between the value of silver abroad and its value in China as found by the Central Bank of China. This far-reaching action was necessary because the outward flow of essential monetary stocks could not otherwise be checked. The measure was the first step toward abandonment of the old silver standard. It immediately halted exports of silver through legitimate channels, although smuggling of silver continued on an important scale—at one time the value of silver outside China exceeded its value within the country by as much as 65 per cent. The export restriction checked the rise in exchange and correspondingly checked deflation. The authorities, however, deemed it advisable to allow exchange to follow somewhat the fluctuations in the external value of silver, due largely to a desire to prevent the margin from becoming so large as unduly to stimulate smuggling of silver.

The monetary régime under the export restrictions was obviously a temporary makeshift. It became increasingly apparent during 1935 that no fundamental solution had been accomplished, and that conditions would drift on to a grave banking crisis and probably to financial collapse unless more far-reaching reforms were undertaken. One faction, including some influential foreign bankers, wanted restoration of the old silver standard. What such a policy, even if feasible, would have meant is indicated by the fact that in Hongkong, which remained on the silver basis for a time, the price index in the summer of 1935 fell to under 70, as compared with 90.5 in Shanghai—the two indices earlier having stood at near the same figure. A few favored adoption, immediately after the silver export restriction, of a lower level of exchange similar to that later adopted; this measure to be followed by sales of silver, departure from the silver basis, and adoption of an exchange standard. Plans for such a reform were worked out at that time, a year before finally placed in effect. In the fall of 1934, however, there would have been not only tremendous inertia to overcome but very strong opposition to such a reform. Further suffering by the financial community and the public was required before they were impressed with the necessity of changing fundamentally the old silver basis.

One of the chief questions of policy during 1934-1935 was whether a reform could be effected by China out of its own resources or only with support of a foreign loan. The Central Bank had already been accumulating foreign currency reserves, favored by the heavy exports of silver and gold, and it was clear that definite stabilization of

exchange at a lower level would create conditions favorable to the augmenting of such reserves. Nevertheless procurement of a loan was highly desirable because it would add to confidence in the reform and, by strengthening currency reserves, would enhance the likelihood of success. But with strained relations between China and Japan, there were serious political complications, apart from the doubts resulting from the unsatisfactory state of China's public finances and the bad economic condition of the country. Loan negotiations would take time and might eventually fail. With the situation deteriorating, something had to be done in any case, and the chances of success might be lessened if conditions became too serious.

During 1935 the governments chiefly interested in Chinese financial conditions engaged in discussions concerning the practicability of constructive measures for international support of monetary stabilization in China. The proposal which emerged from these discussions was that American, British, French and Japanese experts should visit China, to discuss the problem on the ground with the Chinese government. The governments, however, were unable to agree even on this formula, and the result was that only the British expert, Sir Frederick Leith-Ross, went to China. Soon after his arrival and before measures of external assistance could be devised, the financial situation deteriorated to such a point that the government was compelled to take action on the lines previously prepared. On November 3, 1935 the government announced the reform. Exchange was to be stabilized at an agreed level, since for political reasons it was not advisable to tie the Chinese unit to any single foreign unit; silver was nationalized; and notes of the Central Bank of China, the Bank of China and the Bank of Communications were made legal tender. The reform was to be buttressed through reorganization of the Central Bank as the Central Reserve Bank of China and through balancing of the budget within 18 months.

The introduction of the reform was facilitated by helpful action by both the American and British governments. The latter, through its Ambassador in China, at once issued an Order in Council prohibiting British subjects in China from making payments in silver, the order being in line with the Chinese government's decree. This measure, which was necessary to relieve British subjects of possible legal liability, materially added to confidence in the reform because it showed the cooperation of the British government and insured the support of the influential British community.

In the fall of 1935 the friendly disposition shown by the American Treasury indicated the probability that substantial amounts of silver could be sold to provide funds for strengthening the reform. Negotiations progressed favorably during October 1935. Shortly after the reform of November 3, 1935, the sale of a substantial amount of silver to the United States was announced, thereby providing an invaluable addition to the fund for maintenance of exchange stability, and further adding to confidence in the reform.

In devising the basis for reform, those responsible relied extensively, and as it proved correctly, on the beneficial effects which would result from announcement of the stabilization of the currency at a suitable new level. Since the heavy exportation of silver for many months past had reduced the circulation to much below normal, it was felt that with stabilization the demand for currency would cause the market to sell cash exchange to the Central Bank, thereby adding to its balances abroad. This was actually what happened. Furthermore, it was felt that adoption of currency reform on the contemplated basis at the depth of the depression would check deflation and restore confidence, with consequent encouragement to trade. This, together with encouragement through lower exchange of remittances to China by overseas Chinese, which are a very important factor in China's balance of payments, was relied upon to enable the Central Bank to increase the external currency reserves.

The reform was a conspicuous success from the outset. Several times the position of the monetary authorities was tested by speculators, especially at times of adverse internal or external events. Each time, however, the government banks were free sellers of exchange, both for cash and forward, and the speculators eventually had to settle their contracts at a loss, to the consequent profit of the banks. The substantial improvement of internal economic conditions made possible by the reform, and promoted by favorable crops and economic improvement abroad, enabled the acquisition of large additional reserves of foreign currencies. These resources were augmented by the cooperation of the American Treasury in further exchange of U. S. dollars and gold for silver. In the spring of 1936 Mr. K. P. Chen, together with Ambassador Sze, concluded arrangements with the American government for the sale of further quantities of silver and for making available U. S. dollar exchange for currency stabilization. The Chinese government announced at that time its intention to maintain adequate reserves against note issue consisting of gold, foreign exchange and silver, the silver portion of the reserves to have a value equivalent to at least 25 per cent of the note circulation.

In July 1937 Minister Kung made a further arrangement with the American authorities for provision of U.S. dollar exchange for stabilization.

Since November 1935 exchange has enjoyed a stability not previously known in China, and the currency system has commanded confidence at home and abroad. In the spring of 1937 steps were being taken to complete the structure of monetary reform by converting the Central Bank into a Central Reserve Bank, in pursuance of the undertaking contained in the government's announcement of November 3, 1935. Following the work of the expert committee which drafted a new charter for the Central Reserve Bank, and after long discussions in Nanking, a plan of reform on modern lines was finally adopted in June 1937, and was about to be placed into effect when the Sino-Japanese hostilities broke out. Measures were also being taken to institute a reform of the banking system in order gradually to eliminate defects which have proved an element of weakness. This program of banking reform, however, was also held up by the Sino-Japanese hostilities.

The Ministry of Finance had meanwhile been reforming monetary conditions in the western and southern parts of the country. In Szechuen province steps were taken looking toward replacement of the chaotic circulation of depreciated coins and notes by dollar currency. In the Canton region the "small money dollar" notes—based formerly on five depreciated silver 20-cent coins—were being withdrawn and national currency substituted.

Substantial progress had been made toward introduction of a decimal system of subsidiary money. For several years fractional paper banknotes had been tending to supplant the old, depreciated silver 20- and 10-cent coins. At the beginning of 1936 the government commenced the circulation of 20-, 10- and 5-cent pure nickel coins and 1- and ½-cent copper coins, the product of the Central Mint at Shanghai. These coins were in great demand from the public, and the program called for substituting them both for the fractional paper money and for the various copper coins which still form an important part of the circulating medium.

Thus, in a brief time, China's monetary system was being transformed and modernized, to the great benefit of the people of the country and also of other countries trading with and having interests in China.

FOREIGN LOAN SETTLEMENTS

Governmental loans are a comparatively recent development in China. Aside from a few relatively small borrowings, no external debt was contracted before the foreign loans of 1895-1898, and no internal loan was successfully floated prior to the advent of the Republic in 1911. China's debt has been incurred for three main purposes: for indemnities, or loans in connection therewith following the Sino-Japanese war of the nineties and the Boxer uprising of 1900; for constructive purposes, chiefly railways; and to cover governmental deficit. As of July 1, 1937, China's total debt was equivalent to roughly $4,500,000,000, Chinese currency or, say, U.S. $1,350,000,000. Approximately three-fourths of this was under charge of the Ministry of Finance and most of the rest was railway debt. Somewhat over half was internal debt. The principal amount of debts in arrears not yet settled was roughly a tenth of the total outstanding principal—but some years earlier unsettled debts had been a third or more of the total.

Apart from a brief period following the Revolution of 1911, customs-secured foreign obligations have been regularly paid. Salt-secured loans were also regularly paid up to 1927, in spite of the seizure of salt revenue by regional authorities. But in 1927-1928 these seizures did not leave enough to meet even the relatively small loan payments that had to be provided out of salt revenue. Meanwhile, the railway system was disintegrating due to requisition and destruction of equipment during civil wars, and to seizure of railway revenue by regional authorities. When the National Government signalized its triumph by the capture of Peking in 1928, virtually all the national debt other than customs-secured foreign obligations was in arrears.

The Nationalist program included the rehabilitation of China's credit. With revenues that were grossly inadequate and with a country disorganized and at times and in places even chaotic, the task was indeed formidable. Nevertheless, the government made a beginning with the salt-secured loans, by instituting the system of loan quotas as mentioned. Fortunately, the arrears due from salt revenue were not very large. The program announced by Finance Minister T. V. Soong in September 1929 provided for: (1) immediate payment of the arrears of interest on the Anglo-French Loan of 1908, the senior loan; (2) increase of the salt revenue contribution for the Hukuang Railway Loan of 1911, over and above the contractual payment, so that one coupon could be paid from salt revenue each June; (3) extra payments of interest coupons in arrears of the Crisp Loan of 1912, so as to clear these arrears at an early date; and (4) extra payments of arrears of principal of the Anglo-French and Crisp loans after interest arrears

were paid. These measures affected about £13,000,000 principal amount of outstanding bonds.

Athough civil wars, the depression and the slump in silver forced some delay in carrying out part of the program, it was on the whole a conspicuous success. By the end of 1934 all the program had been carried out except payment of the arrears of principal of the Crisp loan, and two instalments instead of one were being paid each year so that the loan would be entirely restored to schedule by 1940. These accomplishments are particularly noteworthy in a time of internal and external confusion, both economic and political, when defaults were increasing throughout most of the remainder of the world.

The next debts to be settled were those incurred by the Ministry of Communications for telegraph and telephone development. Virtually all such debts were settled in 1934-1935, after protracted negotiations. The chief creditors were Japanese concerns; British, American and German companies were owed lesser amounts. The total capital amount of these debt settlements is equivalent to about $55,000,000 Chinese currency.

Meanwhile, with the country settling down and with conditions of railway operation improving, the Ministry of Railways was in position to begin negotiations with holders of railway obligations. After settlements with a number of creditors who had supplied materials, negotiations were undertaken with representatives of holders of the chief railway bond issues that were in arrears. The first to be settled were the Tientsin-Pukow Railway Loans of 1908-1910, which enjoyed a contingent claim on customs as well as railway revenue, the outstanding principal being about £6,150,000. In order to facilitate these negotiations, the Bank of England appointed a special committee in London. After extended negotiations, the Ministers of Finance and Railways announced on February 25, 1936 the terms of an offer whose acceptance was recommended to holders by the committee. This offer may be summarized as follows: (1) interest to be 2½ per cent for 1936-1938 and 5 per cent (the contractual rate) thereafter; (2) principal to be repaid from 1940-1975 by applying increasing percentages of the gross earnings of the line; (3) interest arrears (including the 2½ per cent interest not paid during the 1936-1938 period) to be figured at 1 per cent per annum simple interest, for which amount non-interest-bearing scrip would be issued, payable from 1941-1960; and (4) payments to be made out of railway revenue, any deficiencies in the sums required for interest to be made up out of customs revenue. The railway enjoyed substantial and increasing earnings, having returned to a profitable state, and it was not anticipated that there would be any occasion to call on customs revenue.

The conclusion of this important settlement facilitated others. During 1936 and the first half of 1937 active negotiations took place, with the result that settlements of the greater part of the remaining debts in arrears were made. The following are among the more important settlements other than those already mentioned: the Vickers and Marconi sterling treasury notes of 1918-1919; the Chicago Bank and the Pacific Development Corporation loans of 1919; and bond issues of the Honan, Canton-Kowloon, Peiping-Hankow, Nanchang-Kiukiang, Lunghai and Hukuang railways. The principal foreign interests concerned in the various debt settlements were American, Belgian, British, Dutch, French, German and Japanese.

Altogether, debts in arrears aggregating in principal amount about $850,000,000, Chinese currency, or say U. S. $250,000,000, were settled. Among unsettled claims arising from loans there remained chiefly the so-called Skoda or ex-Austrian loans of 1912-1914, held by continental Europeans; the French Pukow Port Works loan of 1914; a number of Japanese claims, including the Tsingtao Treasury Notes of 1922, the Japanese portion of the "96 million loan" of 1922, and the Nishihara loans of 1917-1918; and certain internal obligations (including floating debt) of the old Peking régime. The total principal amount of unsettled claims may be taken roughly as about 10 per cent of China's total debt. Otherwise stated, about two-thirds of the total of claims arising from loans had been settled, including nearly all the amounts of publicly issued bonds.

These notable settlements were made possible by the desire of the Chinese government to restore its credit, and by the willingness of creditors to make concessions. The burden of increased payments was tempered by a gradually rising schedule, paralleled by gradually decreasing charges in favor of the older loans. China's total national debt (provincial and local debts are only about $200,000,000, Chinese currency) is small in relation to the country's potentialities and, apart from international complications, there was every reason to anticipate continued improvement in China's credit.

Prior to the recent outbreak of hostilities, quotations of Chinese external loans had attained a gratifying level. Several of the chief loans were quoted in the London market near or above par to yield less than 5 per cent per annum. These quotations were nearly double those ruling ten years previously. Also the quotations of internal bonds at Shanghai were steadily improving, although not yet satisfactory. The carrying-out of the reform of

the Central Bank of China and other contemplated measures, together with the general improvement in the situation, would have permitted the quotations of these loans in the relatively near future to attain to a reasonably satisfactory level. This would have materially reduced the cost of government financing.

The success of loan negotiations conducted by Minister Kung in the spring and summer of 1937 indicated that at last foreign capital would be available on an important scale to finance economic developments in China. But the vista of progress thus being opened up was unhappily marred by the outbreak of hostilities.

CONCLUSION

The ten years prior to June 1937, a brief period in the life of a nation, had seen in China a transformation with few parallels in history. In 1927 the internal situation was chaotic. The country was torn by civil war and ravaged by banditry. There was no central authority to speak for the country. Railways were disrupted and largely in the hands of warlords. Roads and airways were almost nonexistent. There was no uniformity of currency, no decimal monetary system. Mediaeval fiscal practices were the general rule, with only the rudiments of a system of modern financial administration. The government could not strengthen itself because of inadequacy of revenue sources, and could not develop adequate revenues because of lack of authority. Internationally, China was viewed as a liability and numerous schemes were proposed for dealing with the "problem of China" and for accomplishing measures of reconstruction.

The success of the Nationalist movement broke the vicious circle and opened the way for the soundest type of reconstruction—a building-up based primarily on China's own efforts. These ten years have seen the spread of the Central Government's authority to all parts of the country. Warlords have been defeated, have thrown in their hands or have become loyal members of the government. Although communism had not been entirely eliminated, it had ceased to be a factor of first importance by the middle of 1937. Banditry was being gradually exterminated. The railway system was restored and its administration improved, new lines were built, and a comprehensive scheme of development was being carried out. Air lines covered in hours distances previously requiring days or weeks. Currency reform had become a reality instead of an aspiration. Adequate public revenues and a modern system of financial administration were being developed. The reforms of the past ten years bear comparison with the financial measures adopted in the early days of the American Republic.

On the whole, China's progress had acquired a momentum that was remaking the country and carrying it along in spite of difficulties. China was becoming a stronger factor in the world situation, and potentially a notable addition to the stabilizing forces in a period of extreme world-wide difficulty. In this situation came the Japanese seizure of Peiping and Tientsin and the hostilities following the despatch of the Japanese fleet to Shanghai. The full results of these measures of aggression are for time to show. There can be no doubt, however, that the interruption of China's progress in self-development is one of the great tragedies of history.

[*The following paragraphs, constituting a brief summary of China's financial condition in recent months, have been added to Mr. Young's report by T. A. Bisson, of the Foreign Policy Association research staff.*]

China's finances have stood up remarkably well under the strain imposed by the hostilities which began in July 1937. Customs collections for 1937, as a result of favorable trade conditions during the first seven months, aggregated 342.9 million dollars, Chinese currency.[6] This was the largest revenue collection from China's maritime customs in the country's history, with the single exception of the year 1931. Chinese foreign loan and indemnity bonds, as well as internal loan issues, have been regularly serviced. In 1937 these payments totalled 214.7 million dollars, Chinese currency, of which 85.6 million was for interest and principal on foreign-held bonds and 129.1 million on internal issues. After meeting these obligations, the Chinese government had at its disposal the net balance of 128.2 million from customs revenue. This, also, was the highest such figure in recent years.

Extensive year-end surveys of China's financial status, conducted by European and American experts, maintain a guarded optimism.[7] During 1937, it was estimated, the Chinese government had expended somewhat over 100 million dollars, American currency, for munitions and war supplies. On January 1, 1938 an additional 25 million dollars'

6. For these figures, cf. summary of financial statement by Dr. H. H. Kung, Chinese Finance Minister, in *The Oriental Economist* (Tokyo), February 1938, p. 74.

7. *New York Times,* February 20, 1938.

worth of munitions had been ordered but not yet delivered. On the same date cash reserves of the Chinese government held abroad, principally in New York and London, were estimated at roughly 300 million U. S. dollars. The reported summary of the experts' observations concluded: "Were it not for the necessity of keeping intact a large slice of this fund to act as a reserve back of Chinese national currency, China's financial position would indeed be bright, despite nearly six months of devastating war on her own soil."

The fiscal reforms effected by the National Government in recent years, it seems clear, have proved their soundness under a searching test. Chinese currency, in the face of war conditions, has been maintained at a stable level. Resources for the purchase of munitions are still available. Customs collections during 1938, as the result of Japanese control of port cities such as Shanghai, Tientsin and Tsingtao, will sharply contract—a factor which will probably force the declaration of a moratorium on external and internal loan payments. It is understood that such a moratorium is now under contemplation, and will be applied to payments on principal but not on interest. The application of this emergency measure should relieve the immediate strain on China's finances. For the near future, at least, there seems no reason to believe that China's military resistance will collapse for lack of financial resources.